CUMBERLAND

Cumberland Income Fund
First Quarter 2013 Review and Outlook

The Cumberland Income Fund generated a return of +1.8% for the first quarter of 2013. By comparison, the DEX Universe Bond Index generated a return of +0.7% over the same period. The Fund's dividend paying equity allocation and income generated from the higher yielding corporate bonds were the main contributors to the performance this quarter. To a lesser extent, the Fund was also a beneficiary of the slight decline in Canadian interest rates that occurred during the quarter.

Arguably, the first quarter of 2013 will be remembered (or perhaps forgotten?) as the quarter when the great rotation out of bonds and into equities did <u>not</u> occur. At the beginning of the year, some market participants speculated that investors would begin selling their bonds and replacing them with equities. These market participants believed that investors would not want to continue to hold very low yielding (i.e. expensive) bonds in hopes that these yields would fall further (i.e. become even more expensive). They expected money to flow into equities from bonds especially given the partial resolution of the "fiscal cliff" at the beginning of the year, the absence of bad news out of Europe, and the attractive valuations existing in the equity markets. Indeed, as the quarter progressed, fund flows data showed that investors were actually adding to equities at the fastest rate since 2007. The funds, however, were not coming out of bonds as some market participants had expected. They came from cash and money market funds, meaning investors were putting new money to work. So while equities did enjoy a resurgence in the first quarter, it was not at the expense of bonds as fund flows into bond funds still outpaced flows into equity funds.

Interest rates trended higher during the first half of the quarter as the Canada 10-year bond (GCAN10YR) yield rose from 1.8% at the beginning of January to 2.07% by the middle of February. It was around this time that the U.S. Federal Reserve Open Market Committee (FOMC) released the minutes of their January meeting stating there were concerns over the potential costs (risks) of continuing to purchase US$85 billion of bonds monthly to stimulate the economy (QE). Bond investors interpreted the statement such that QE may be coming to an end earlier than expected thereby putting the tepid economic recovery at risk. This created a flight-to-safety trade that saw government bond yields begin to fall (and prices rise). Shortly thereafter, there was a resurgence of the ongoing yet eerily silent Eurozone crisis. First there was news of the Italian election results where no party received enough votes to form an effective coalition government. Observers of the election believed this could possibly lead to the revival of the free spending former Prime Minister, Silvio Berlusconi. Government bond yields in Canada and the U.S. responded by declining further (and prices rising higher). A short two weeks later, Cyprus officially announced their banking crisis to the world and the draconian terms of seizing customer bank deposits to help contribute to the country's "bailout". By the time all these "uncertainties" had been reflected in the bond market, the GCAN10YR bond yield dropped from the intra-quarter high of 2.07% to end the quarter at the intra-quarter low of 1.76%.

Despite the risk averse attitude suggested in the government bond market by the decline in interest rates from mid-quarter onwards, the corporate bond market more closely tracked the buoyant equity markets. Corporate spreads (the yield premium over government bonds) performed well during the quarter, compressing each month. In our view, corporate bonds continue to be more attractive than government bonds since they offer a higher yield. Furthermore, corporate balance sheets remain generally robust resulting in default rates below historic average levels. Canadian corporate issuers continued to take advantage of the low interest rate environment and strong investor demand by issuing C$29 billion in new bonds during the quarter, exceeding last quarter's issuance by C$4 billion.

Cumberland's Income Fund initiated several new positions during the quarter. Within the corporate bond segment, we added bonds from a new Canadian issuer, Penske Truck Leasing along with adding new bonds from issuers we already hold positions with - Corus Entertainment and RIOCAN REIT. In the equity segment, we participated in the IPO of American Hotel Income Properties REIT, a company which operates a chain of niche hotels that caters specifically to the railroad industry. This issue was offered at an attractive dividend yield of 9%.

At Cumberland, we continue to believe that the possibility of rising interest rates is the greatest risk to bond prices in this ultra-low interest rate environment. However, with GDP growth stuck at around 2%, and the Federal Reserve (Fed) looking for an improvement in labour market conditions and inflation expectations before removing monetary stimulus, we expect interest rates in Canada and the U.S. to remain range bound albeit with a bias to drifting higher. The debate that now rages is when will Fed Chairman Ben Bernanke begin to reduce monetary stimulus by reducing the rate at which the bonds are being purchased. Given benign inflation indicators and stubbornly high, albeit improving unemployment levels, we expect the current rate of bond buying to continue through at least the end of the summer thereby supporting our view that interest rates will be range bound in the short term.

In this low interest rate environment, our focus is on corporate bonds which tend to offer higher income than government bonds. We also supplement this income from bonds with dividend income generated from high yielding preferred and common shares. In addition, we continue to maintain 25% of the Fund invested in floating rate notes (mostly within our Government bond allocation) to help offset the negative impact that rising interest rates could have on bond prices. This, combined with disciplined credit analysis and keeping the duration short at around three years should allow us to continue to deliver on our objectives of preserving capital and generating income.

Asset Allocation as at March 28, 2013

Asset Class	% of Portfolio
Cash and Cash Equivalents	9.0%
Government Bonds (incl. Floating rate notes)	30.3%
Corporate Bonds	45.1%
Preferred Shares	7.8%
Equities/Income Trusts	7.8%

Yield[1] Comparison as at March 28, 2013

DEX Universe	2.23%
DEX Government	2.05%
DEX Corporate	2.67%
Cumberland Income Fund[2]	3.51%

1. Yield is the rate of income generated on an annualized basis. Yield does not represent the total return of the Fund or the Indices shown in the above table.
2. Gross of fees